

limitation, deductions against net recognized built-in gain, and credits against the section 1374 tax.

(c) *Section 1374 attributes.* Section 1374 attributes are the loss carryforwards allowed under section 1374(b)(2) as a deduction against net recognized built-in gain and the credit and credit carryforwards allowed under section 1374(b)(3) as a credit against the section 1374 tax.

(d) *Recognition period.* The recognition period is the 10-year (120-month) period beginning on the first day the corporation is an S corporation or the day an S corporation acquires assets in a section 1374(d)(8) transaction. For example, if the first day of the recognition period is July 14, 1996, the last day of the recognition period is July 13, 2006. If the recognition period for certain assets ends during an S corporation's taxable year (for example, because the corporation was on a fiscal year as a C corporation and changed to a calendar year as an S corporation or because an S corporation acquired assets in a section 1374(d)(8) transaction during a taxable year), the S corporation must determine its pre-limitation amount (as defined in § 1.1374-2(a)(1)) for the year as if the corporation's books were closed at the end of the recognition period.

(e) *Predecessor corporation.* For purposes of section 1374(c)(1), if the basis of an asset of the S corporation is determined (in whole or in part) by reference to the basis of the asset (or any other property) in the hands of another corporation, the other corporation is a predecessor corporation of the S corporation.

[T.D. 8579, 59 FR 66463, Dec. 27, 1994]

§ 1.1374-2 Net recognized built-in gain.

(a) *In general.* An S corporation's net recognized built-in gain for any taxable year is the least of—

(1) Its taxable income determined by using all rules applying to C corporations and considering only its recognized built-in gain, recognized built-in loss, and recognized built-in gain carryover (pre-limitation amount);

(2) Its taxable income determined by using all rules applying to C corporations as modified by section

1375(b)(1)(B) (taxable income limitation); and

(3) The amount by which its net unrealized built-in gain exceeds its net recognized built-in gain for all prior taxable years (net unrealized built-in gain limitation).

(b) *Allocation rule.* If an S corporation's pre-limitation amount for any taxable year exceeds its net recognized built-in gain for that year, the S corporation's net recognized built-in gain consists of a ratable portion of each item of income, gain, loss, and deduction included in the pre-limitation amount.

(c) *Recognized built-in gain carryover.* If an S corporation's net recognized built-in gain for any taxable year is equal to its taxable income limitation, the amount by which its pre-limitation amount exceeds its taxable income limitation is a recognized built-in gain carryover included in its pre-limitation amount for the succeeding taxable year. The recognized built-in gain carryover consists of that portion of each item of income, gain, loss, and deduction not included in the S corporation's net recognized built-in gain for the year the carryover arose, as determined under paragraph (b) of this section.

(d) *Accounting methods.* In determining its taxable income for pre-limitation amount and taxable income limitation purposes, a corporation must use the accounting method(s) it uses for tax purposes as an S corporation.

(e) *Example.* The rules of this section are illustrated by the following example.

Example: Net recognized built-in gain. X is a calendar year C corporation that elects to become an S corporation on January 1, 1996. X has a net unrealized built-in gain of \$50,000 and no net operating loss or capital loss carryforwards. In 1996, X has a pre-limitation amount of \$20,000, consisting of ordinary income of \$15,000 and capital gain of \$5,000, a taxable income limitation of \$9,600, and a net unrealized built-in gain limitation of \$50,000. Therefore, X's net recognized built-in gain for 1996 is \$9,600, because that is the least of the three amounts described in paragraph (a) of this section. Under paragraph (b) of this section, X's net recognized built-in gain consists of recognized built-in ordinary income of \$7,200 [$\$15,000 \times (\$9,600 / \$20,000) = \$7,200$] and recognized built-in capital gain of \$2,400

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[\$5,000×(\$9,600/\$20,000)=\$2,400]. Under paragraph (c) of this section, X has a recognized built-in gain carryover to 1997 of \$10,400 (\$20,000−\$9,600=\$10,400), consisting of \$7,800 (\$15,000−\$7,200=\$7,800) of recognized built-in ordinary income and \$2,600 (\$5,000−\$2,400=\$2,600) of recognized built-in capital gain.

[T.D. 8579, 59 FR 66463, Dec. 27, 1994]

§ 1.1374-3 Net unrealized built-in gain.

(a) *In general.* An S corporation's net unrealized built-in gain is the total of the following—

(1) The amount that would be the amount realized if, at the beginning of the first day of the recognition period, the corporation had remained a C corporation and had sold all its assets at fair market value to an unrelated party that assumed all its liabilities; decreased by

(2) Any liability of the corporation that would be included in the amount realized on the sale referred to in paragraph (a)(1) of this section, but only if the corporation would be allowed a deduction on payment of the liability; decreased by

(3) The aggregate adjusted bases of the corporation's assets at the time of the sale referred to in paragraph (a)(1) of this section; increased or decreased by

(4) The corporation's section 481 adjustments that would be taken into account on the sale referred to in paragraph (a)(1) of this section; and increased by

(5) Any recognized built-in loss that would not be allowed as a deduction under section 382, 383, or 384 on the sale referred to in paragraph (a)(1) of this section.

(b) *Example.* The rules of this section are illustrated by the following example.

Example: Net unrealized built-in gain. (i) (a) X, a calendar year C corporation using the cash method, elects to become an S corporation on January 1, 1996. On December 31, 1995, X has assets and liabilities as follows:

Assets	FMV	Basis
Factory	\$500,000	\$900,000
Accounts Receivable	300,000	0
Goodwill	250,000	0
Total	1,050,000	900,000
Liabilities	Amount	
Mortgage	\$200,000	

Assets	FMV	Basis
Accounts Payable	100,000	
Total	300,000	

(b) Further, X must include a total of \$60,000 in taxable income in 1996, 1997, and 1998 under section 481(a).

(ii) If, on December 31, 1995, X sold all its assets to a third party that assumed all its liabilities, X's amount realized would be \$1,050,000 (\$750,000 cash received+\$300,000 liabilities assumed=\$1,050,000). Thus, X's net unrealized built-in gain is determined as follows:

Amount realized—	\$1,050,000
Deduction allowed—	(100,000)
Basis of X's assets—	(900,000)
Section 481 adjustments	60,000
Net unrealized built-in gain—	110,000

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§ 1.1374-4 Recognized built-in gain or loss.

(a) *Sales and exchanges—*(1) *In general.* Section 1374(d)(3) or 1374(d)(4) applies to any gain or loss recognized during the recognition period in a transaction treated as a sale or exchange for Federal income tax purposes.

(2) *Oil and gas property.* For purposes of paragraph (a)(1) of this section, an S corporation's adjusted basis in oil and gas property equals the sum of the shareholders' adjusted bases in the property as determined in section 613A(c)(11)(B).

(3) *Examples.* The rules of this paragraph (a) are illustrated by the following examples.

Example 1. Production and sale of oil. X is a C corporation that purchased a working interest in an oil and gas property for \$100,000 on July 1, 1993. X elects to become an S corporation effective January 1, 1996. On that date, the working interest has a fair market value of \$250,000 and an adjusted basis of \$50,000, but no oil has as yet been extracted. In 1996, X begins production of the working interest, sells oil that it has produced to a refinery for \$75,000, and includes that amount in gross income. Under paragraph (a)(1) of this section, the \$75,000 is not recognized built-in gain because as of the beginning of the recognition period X held only a working interest in the oil and gas property (since the oil had not yet been extracted from the ground), and not the oil itself.

Example 2. Sale of oil and gas property. Y is a C corporation that elects to become an S corporation effective January 1, 1996. Y has two shareholders, A and B. A and B each own